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No.

IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1984

A.W.JONES COMPANY, MILTON PHILLIPS, Trustee for Milton Phillips Pension Trust, Individually and on behalf of all others similarly situated,
Petitioners,

v.

JEFFERIES & CO., INC.
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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November 27, 1984

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QUESTIONS PRESENTED

This is a case of first impression which involves a major departure from the accepted and approved course of administering interpleader claims. The case involves the district court's sanctioning of the interpleading plaintiff's discrediting of its own interpleader claim at trial, albeit sans any advance resort to the dismissal or amendment provisions provided by Rules 41(a) and 15(a) of F.R. Civ.P., respectively, and without any accompanying leave to amend extended to the claimants of the interplead res.

This case also presents important securities law questions concerning interpretations of §§12(1) and 12(2) of the 1933 Securities Act which defy

traditional constructions of the 50 year-old legislation scheme. In effect, this case marks the first instance in which a court, having considered the merits of a statutory underwriter's sale of securities covered by a totally fraudulent registration statement and prospectus, failed to invalidate the sale. So, too, the case departs from the unbroken line of decisions among the circuits which require sellers of securities, inclusive of brokers, to demonstrate reasonable care in ascertaining the existence of material misstatements in an underlying prospectus as §12(2) of the 33 Act so clearly mandates.

The Questions Presented are:

1. Should an interpleading party, which has availed itself of the protections afforded by Rule 22

of F.R. Civ.P., be permitted to discredit its own interpleader claim at trial absent any prior attempt to seek leave to dismiss or amend and sans any corresponding leave to the claimants of the interplead res to amend?

2. Does a non-exempt statutory underwriter's sale of securities on behalf of a controlled subsidiary and controlling person of the issuer, the securities of which are covered by a "sham" registration statement and prospectus, subject the selling broker to liability to the ultimate purchasers by virtue of §§ 5b(2) and 12(1) of the Securities Act?

3. Is a broker who has sold securities covered by a prospectus containing misrepresentations of material fact liable to the ultimate purchasers, where the broker is shown to have failed to carry it burden of proof imposed by §12(2) of the 1933 Securities Act, which requires a demonstration that the seller didn't know of the misrepresentations and in the exercise of reasonable care could not have learned of the same?

PARTIES

Two cases were consolidated, both for trial and for review in the Court of Appeals. Petitioners - appellants in the Court below - are:

> A.W. Jones Co., Milton Phillips, Trustee for the Milton Phillips Pension Trust, Individually and on behalf of all others similarly situated.

Respondents - appellee in the Court below - are:

> Jefferies & Co., Inc.

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IN THE
SUPREME COURT OF THE UNITED STATES

October Term, 1984

No.

IN RE EQUITY FUNDING CORPORATION
OF AMERICA SECURITIES LITIGATION

A.W. JONES COMPANY, MILTON PHILLIPS,
Trustee for Milton Phillips Pension
Trust, Individually and on behalf of all
others similarly situated,
Petitioners ,
v.

JEFFERIES & CO., INC.,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE COURT OF APPEALS FOR THE EIGHTH CIRCUIT

Petitioners A.W. Jones and Milton Phillips, et al., respectfully petition this Court, pursuant to 28 U.S.C. § 1254(1) and Rule 19 of the Rules of this Court, for a writ of certiorari to the United States Court of Appeals for the Eighth Circuit, in the case of Jefferies & Co., Inc. v. A.W. Jones Co., et al. (no. 83-1833).

OPINIONS BELOW

The opinion of the Court of Appeals is unreported and is attached at Appendix A. The opinion of the District Court for the Western District of Missouri is unreported and is attached as Appendix B. The District Court's order of November 7, 1979 is unreported and is attached as Appendix C. The

opinion of the District Court for the Southern District of New York is reported at 357 F.Supp. 1206 (SDNY 1973) and is attached as Appendix D.

JURISDICTION

The judgment of the Court of Appeals was entered on August 29, 1984. This Court has jurisdiction to review the decision of the Court of Appeals under 28 U.S.C. § 1254(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS

The following statutory and regulatory provisions are pertinent to this case:

STATUTORY PROVISIONS

Title 15 U.S.C. Sec. 77J(a), set

forth in Appendix E;

Title 15 U.S.C. Sec. 771, set forth in Appendix F;

Title 15 U.S.C. Sec. 77e, set forth in Appendix G;

Title 15 U.S.C. Sec.77b(11), set forth in Appendix H;

Title 15 U.S.C. Sec. d(1)(4), set forth in Appendix I.

REGULATORY PROVISIONS

Rule 15 (a)(b) of Federal Rules of Civil Procedure, set forth in Appendix J;

Rule 22 of Federal Rules of Civil Procedure, set forth in Appendix K;

Rule 41 (a)(2) of Federal Rules of Civil Procedure, set forth in Appendix L;

Title 17 C.F.R. Section 230.144(g), set forth in Appendix M.

STATEMENT OF THE CASE

This case, a consolidation of companion cases initiated by respondent in the Southern District of New York and the Western District of Missouri,

concerns (a) the misuse of the Rule 22 interpleader procedures by an interpleading plaintiff who discredited its own interpleader claim at trial sans any leave to dismiss or amend its claim and (b) the respondent broker's public sale of securities on behalf of a controlled subsidiary and controlling person of the issuer (EFCA), the securities of which were covered by a "sham" registration statement and prospectus, all without any inquiries to ascertain the identity of its customer or the condition of the issuer and in the face of plummeting prices of EFCA stock.

A. Trial Proceedings

A detailed summary of the facts surrounding EFCA was contained in this Court's decision in Dirks v. SEC, 459

U.S. 1014 (1983) and in the decision of the trial court below and will be given only brief treatment herein.

Equity Funding Corporation of America (EFCA) involved perhaps the most publicized and extensive fraud in the history of the public trading markets. It entailed the issuance of bogus life insurance policies, obtaining cash through reinsuring those policies with other insurers and obtaining proceeds by filing false claims with the reinsurers. EFCA's financial records reflected slavish overstatements of income and assets and corresponding understatements of liabilities as a result of these transactions and other conduct. See decision of trial court below (Appendix B) and this Court's decision in Dirks v. SEC, supra.

On March 26, 1973, Yura Arkus-Duntov ("Duntov"), an officer, director and controlling person of EFCA, sold much of his portfolio of EFCA securities over the NYSE through respondent. The sales were sold on the basis of inside market information traced to the rumors spread by Raymond Dirks in the preceding weeks (Appendices B and D). Over the course of the two weeks before the Duntov sales, EFCA stock had plummeted from $27 a share to $17. See Dirks v. SEC, supra. Jefferies' trading department, upon being informed by other sources within its corporate hierarchy (the evidence established that Jefferies' president and general counsel had business relations with Duntov in the past and knew his associations with EFCA),

undertook to stop the trades. It sought and obtained a preliminary injunction, enjoining the cashing of Jefferies' check for $192,256.35 (No. 22214 made payable to Duntov). Jefferies, in turn, interplead the same funds in favor of the ultimate purchasers of the Duntov shares, who were later identified as the class of purchasers represented by the petitioners (Appendix B).

At trial, Jefferies pronounced that its interplead res never materialized and was perforce not available to petitioners, inasmuch as the anticipated settlement from Shearson Hayden Stone (through the balance order system provided by the Stock Clearing Corporation of the NYSE) never was completed. The trial court, in turn, permitted Jefferies to adduce evidence

of respondent's reasons for declining to fulfill its interpleader commitments (Appendix B).

Despite the fact, however, that the trial court accepted evidence from respondent of the latter's good conduct (attributable to customary practice in the brokerage industry) in its execution of the Duntov trades (evidence adduced at variance with Jefferies' pleadings and pre-trial contentions), the court declined to (a) apply the appropriate rules to such evidence, (b) permit petitioners to offer additional evidence of Jefferies' departures from the statutory and regulatory requirements for member brokers trading on the NYSE or (c) grant leave to petitioners to amend their own pleadings. To the contrary, the trial court allowed

Jefferies to discredit its own interpleader claims and ruled that petitioners had waived their right to wage federal security law violations against Jefferies.

B. Appellate Proceedings

At oral argument, petitioners requested the court of appeals to grant leave to amend their pleadings to conform with the evidence as provided expressly for by Rule 15(b) of F.R.Civ.P. While special leave to amend to conform is not required where the evidence has been admitted without objection, we, nonetheless, sought the special leave as a procedural safeguard. The court of appeals offered no comment on petitioners' request, leaving open serious questions as to how the evidence should be treated as a matter of law in

the proceedings below.

REASONS FOR GRANTING THE WRIT

This case raises important questions in the administration of interpleader under the federal rules. It raises the issue of whether a party who avails itself of Rule 22 interpleader protections may be permitted to use the Rule's safeguards as a sword rather than a shield. And it raises several important challenges to the legal efficacy and integrity of the federal securities laws, which were left unanswered in this Court's decision in Dirks v. SEC, supra.

The challenges presented here are both procedural and substantive. Petitioners and their class relied on

Jefferies'' interpleading of the fund enjoined by Judge Gurfein in Jefferies v. Duntov, supra and accepted the res. It is really immaterial whether Jefferies actually had the fund in tow: It interplead the fund as a neutral stakeholder, making no claim itself and placing no conditions on the availability of the fund. An in addition to interpleading the fund in its New York complaint, Jefferies also asked for (a) relief from any liability and (b) the enjoinder against any collateral claims against Jefferies arising out of the same transactions. See Record on Appeal. Having reaffirmed its interpleader in the pre-trial order and declining to seek amendment or dismissal of its same claims in response to the invitation afforded respondent by

the trial court (Appendix C), respondent chose to discredit its interpleader at trial. Such practice (though permitted by the trial court and implicitly endorsed by the court of appeals) is inconsistent with the equitable precepts of interpleader and encompasses a bad faith use of the vehicle in deflection and to the ultimate detriment of a claimant's alternative pursuit of federal securities violations and the remedies afforded by the 33 Act.

Historically, this Court and the circuits have imposed implicit good faith requirements on parties availing themselves of Rule 22 interpleader protections. The collapse of interpleader claims has uniformly required approved dismissal or amendment actions provided litigants by Rules

41(a) and 15(a) of F.R.Civ.P. See Int'l Minerals & Chemicals Corp. v. Golding-Keene Co., 164 F.Supp. 101, 102 (SDNY 1958). Self-impeachment of a party's interpleader claim at trial, in turn, calls into motion a pleading variance, which this Court has traditionally disfavored. See United States v. Seminole Nation, 299 I.S. 417 (1936); Garrett v. Louisville & N.R. Co, 235 U.S. 308, 313 (1914). At minimum, a party faced with an informal collapse of an interpleader claim at trial should be permitted to amend its pleadings as provided for by Rule 15(a) of F.R.Civ.P. or have its pleadings conformed to the evidence admitted without objection in accordance with Rule 15(b) of F.R.Civ.P. Neither the trial court nor the court of appeals sanctioned any amendments.

Substantive questions concerning the liability provisions of §§ 12(1) and 12(2) of the 33 Act are also at stake here. Consistent with respondent's claims asserted in both its New York and Missouri complaints, the registration statement and prospectus of EFCA were of "sham" quality and should have been treated as non-effective for purposes of §12(1) of the 33 Act. Of course, the undisputed evidence at trial demonstrated that Jefferies (a) sold the EFCA stock on March 26, 1973 (the day before the NYSE suspended trading in the stock) for its customers (North American Equity Corporation, a wholly owned subsidiary of EFCA and identified by Jefferies at trial as one in the same with EFCA) and Duntov (a controlling person of EFCA), (b) with the imputed

public knowledge that EFCA stock had plummeted in price over the previous two weeks while (c) declining to make any inquiries of NAEC to identify its customer and the state of EFCA's financial condition.

Given such a factual showing, liability under § 12(1) for Jefferies was mandated under the Section's strict liability provisions. The record facts similarly mandated liability against Jefferies on §12(2) grounds for failure of the respondent to carry its due diligence burden. However, neither the trial court nor the court of appeals were willing to consider the liability provisions made applicable to respondent's actions in this case, opting instead to hold petitioners to a "waiver" of securities claims. As we

show infra, the lower courts departed from accepted procedures and established historical precedents governing the applicability of §§ 12(1) and 12(2) of the 33 Act. We think this case provides a rich portmanteau in need of unpacking.

1. **The decision below raises an important question whether a party availing itself of Rule 22 interpleader may disregard its pleading commitments at trial in pursuit of relief at variance with its pleadings.**

This case represents a historical departure from the recognized use of Rule 22 interpleader in the federal courts. The circuits have never sanctioned either the informal withdrawal or (as here) the discrediting of interpleader or declaratory relief claims at trial as procedural alternatives to strict procedural

avenues afforded by Rules 41(a) and 15(a) of F.R.Civ.P. Cf. Carter v. Thornton, 93 F.2d. 529, 532 (8th Cir. 1938); Knaust Bros. v. Goldschlag, 28 F.Supp. 188, 189 (SDNY 1933), aff'd, 119 F.2d. 1022 (2d Cir. 1941); Lewis V. Switch Machinery Co. v. Columbia B. Machine Mfg. Co., 22 F.Supp. 705, 708-09 (SDNY 1937).

Both in its pleadings and its pre-trial contentions included in the pre-trial order signed by transferee Judge Malcolm Lucas, Jefferies affirmed its stakeholder role as an interpleader of funds enjoined from payment by Judge Gurfein. See Jefferies & Co., Inc. v. Duntov, et al., supra. Pre-trial admissions add even greater sanctity to a party's pleading commitments and control the future course of the

proceedings. See Lane v. Geiger-Berger Assoc. P.C., 608 F.2d 1148, 1152-53 (8th Cir. 1979); American Surety Co. v. Williford, 243 F.2d 494, 496-97 (8th Cir. 1957); Bassista v. Wier, 340 F.2d 74, 85 (3d Cir. 1965); Stafos v. Missouri Pacific Ry. Co., 367 F.2d 314, 319 (10th Cir 1966). Pre-trial admissions not withdrawn by leave of court stand as matters fully determined as if adjudicated at trial. See Air Exec, Inc. v. Two Jacks, Inc., 584 F.2d 942, 944 (10th Cir. 1978); G & R Corp. v. American Security & Trust Co., 523 F.2d 1164, 1178 (D.C. Cir. 1975). Failure to hold respondent to its pleadings and pre-trial admissions reflected a clear abuse of discretion for which corrective action is clearly warranted.

The use of the interpleader device by respondent in the subject case is a prime example of equitable abuse of Rule 22, for which this Court's supervisory powers should appropriately be invoked. Jefferies' role in these proceedings was characterized early in the case by Judge Gurfein of the Southern District as a rescuer role. In affirming Jefferies' rights to cry halt to the Duntov trades, Judge Gurfein classified Jefferies as follows:

> the broker is the volunteer rescuer of unknown investors who would otherwise have sought the stock. Jefferies & Co., Inc. v. Duntov, et al., supra, at 1215.

In openly pursuing a savior role for the Jones/Phillips'' class of purchasers, Jefferies interplead the funds enjoined by Judge Gurfein and asked the court for

(a) the enjoinder of any claims against Jefferies in any other forum and (b) a determination of non-liability. Taking advantage of its station as a stakeholder under Rule 22, Jefferies, we think, badly abused its procedural protections by later disavowing its interplead res at trial. Respondent's course of action marked a dramatic shift in direction from its pleadings and pre-trial contentions and should not have been permitted. This case, as such, affords this Court an excellent vehicle for rectifying what is a clear departure from accepted judicial procedures under the federal rules.

2. The decision below conflicts with this Court's decisions regarding disallowances of pleading variances and the requirements of good faith in the use of Rule 22 interpleader.

Interpleader is itself a procedural mechanism of the federal rules which is designed to immunize stakeholders from vexatious litigation from persons asserting mutually exclusive claims to a particular res. See 3A Moore's Federal Practice, par. 22.02(1) (3d ed. 1983). As an equitable doctrine, Rule 22 interpleader is subject to the principle of "clean hands." This Court and the other circuits taking up questions involving conflicting uses of the procedure have underscored the inherent "good faith" requirements imposed on persons seeking protection of the rule. See, e.g., Sanders v. American Fertilizer Works, 292 U.S. 190, 200 (1934); Great American Insurance Co. v. Bank of Bellevue, 366 F.2d 289, 293 (8th Cir. 1966); Austin v. Texas-Ohio Gas

Co., 218 F.2d 739, 745-46 (5th Cir. 1955); Walmac Company v. Isaacs, 220 F.2d 108, 112 (1st Cir 1955).

Neither this Court nor the circuits have countenanced pleading variances, which turn on de hors anticipated conditions. See United States v. Seminole Nation, supra; Garrett v. Louisville & N.R. Co., supra. At minimum, courts are required to impose stringent conditions on pleading discreditations and other kindred forms of deflective pleading practices. Leave to amend and sanctions are remedial devices available for deployment against parties who abuse the pleading procedures. Cf. Yoffe v. Keller Industries, Inc., 582 F.2d 982 (5th Cir. 1979). None of these devices were imposed by the courts below. Once

again, we think this is a ripe case for this Court's reimposing strict procedural requirements on parties who make use of the protective sanctuaries afforded by the interpleader rule.

3. The decision below directly conflicts with this Court's liberal guidelines regarding leave to amend.

Both Rule 15(a) of F.R.Civ.P. and this Court's past admonitions to the lower courts demonstrate a strong policy undercurrent in the federal rules for liberal amendment allowances. This Court has counseled the lower courts not to deny leave without "any justifying reason appearing for the denial . . ." Foman v. Davis, 371 U.S. 178, 182 (1962). So, too, the federal rules provide for routine amendment of pleadings to conform to the evidence

received without objection. See Rule 15(b) of F.R.Civ.P. The lower courts permitted no amendments whatsoever, even after special leave to amend to conform to the evidence was requested on appeal.

Ergo, this case presents a classic example of the wisdom for securing liberal amendment allowances: An interpleading party, which prior to trial had declined to collapse its interpleader claims by formal procedures in accordance with the federal rules, disowns it interpleader claim at trial based on adduced evidence that the interplead fund never materialized as anticipated. If the integrity of the federal rules are to retain their cherished station, procedural alternatives must be regularly allowed parties confronted with dramatic

variances in pleading commitments. This case provides another excellent opportunity for this Court to reaffirm its liberal amendment policy.

4. The decision below conflicts with the decisions of other circuits and raises important questions concerning the treatment that should be accorded "sham" registration statements and prospectuses under the registration and liability provisions of the 1933 Securities Act.

Assuming, arguendo, that the lower courts erred in permitting respondent's interpleader to be discredited at trial (a) without consideration of the legal effects of respondent's adduced evidence regarding liability to petitioners and (b) without corresponding leave to petitioners to amend their pleadings to conform to the evidence, or to offer additional evidence of underlying

liability, this Court should take this case to consider the important securities issues raised with respect to Jefferies' role in the sale of Duntov's shares of EFCA securities to petitioners and their class.

Respondent plead the sham character of the Duntov sales in its New York and Missouri complaints, and Judge Gurfein, accordingly, found that the sales by Jefferies' customer (Duntov) were not accompanied by a prospectus conforming to the requirements of Sec. 10(a) of the 33 Act (15 U.S.C. Sec. 77j), which perforce rendered Jefferies' customer (a control person of EFCA) strictly liable for sales of securities not registered in accordance with Section 5 of the 33 Act (15 U.S.C. Sec. 77e). See Jefferies & Co., Inc. v. Duntov, supra.

The trial court never addressed the merits of Jefferies' role in the Duntov trades, finding a "waiver" of any securities claims by petitioners. But in assessing similar claims waged against the co-defendant selling bank (which had sold Duntov's pledged EFCA shares over the NYSE also through Jefferies), the trial court declined to follow Judge Gurfein's application of the Manor Nursing doctrine (SEC v. Manor Nursing Centers, 458 F.2d. 1082, 1098 (2d Cir. 1972), relied on by Judge Gurfein in Jefferies & Co., Inc. v. Duntov, supra). The trial court found a plethora of criticism of the Manor Nursing doctrine, which collectively questioned the use of the Sec. 12(1) strict liability provisions to fraudulent registration statements and accompanying

prospectuses. See, in particular, SEC v. Southwest Coal & Energy Co., 624 F.2d. 1312, 1318-19 (5th Cir. 1980) (citing 2A. Bromberg & Lowenfels, Securities Fraud and Commodities Fraud, par. 6.11 (321) (1979); Comment, Truth Up to the Date of Use as a Requirement for a Section 10(a) Prospectus: The Implications of SEC v. Manor Nursing Centers, Inc., 24 Case W. Res. L. Rev. 771 (1973).

None of the critical authorities cited by the trial court, however, involved "sham" prospectuses (as here). The Manor Nursing doctrine, accordingly, retains its continued vitality in the circuits for cases involving security sales covered by "sham" prospectuses. Cf. Byrnes v. Faulkner, Dawkins & Sullivan, 413 F.Supp. 453, 465-66 (SDNY

1976), aff'd, 550 F.2d 1303, 1312 (2d Cir. 1977) (dictum); A.J. White & Co. v. SEC, 556 F.2d 619, 622 (1st Cir.), cert. denied, 434 U.S. 969 (1977).

The Manor Nursing doctrine applies with equal force as well to brokers selling (as here) for controlled and controlling persons of an issuer. While certain persons are exempted from the registration provisions of Section 5b of the 33 Act (15 U.S.C. Sec. 77e) and perforce the strict liability provisions of Section 12(1) of the same Act (15 U.S.C. Sec. 771 (1)), no exemptions are available to Jefferies under the facts of record. Section 4(1) exempts persons who are not insurers, underwriters or dealers, and Section 4(4) exempts non-solicited brokers' transactions executed from customers' orders on any

exchange or in the over-the-counter market. However, respondent was the conceded selling broker for EFCA's controlled subsidiary (NAEC) and controlling officer-director (Duntov), which individually and collectively rendered Jefferies a statutory underwriter within the definition provided by Section 2(11) of the 33 Act (15 U.S.C. Sec. 77b(11)). Pursuant to Section 2(11), a person is held to be a statutory underwriter who, inter alia,

> offers or sells for an issuer in connection with the distribution of any security, or participates or has a direct or indirect participation in the direct or indirect underwriting of any such undertaking. . .

To qualify for either a Section 4(1) or (4) exemption, it was incumbent upon Jefferies to have demonstrated its

compliance with the requirements of Rule 144(g)(3) (17 C.F.R. Sec. 230.144(g)(3)), which controls both statutory exemptions available to selling brokers. Rule 144(g)(3) requires a broker contemplating a trade in the public trading markets to make certain minimal inquiries before executing the trade. Specifically, Rule 144(g)(3) imposes the burden on the selling broker to demonstrate that:

> (3) After reasonable inquiry is not aware of circumstances indicating that the person for whose account the securities are sold is an underwriter with respect to the securities or that the transaction is part of distribution of securities of the issuer. Without limiting the foregoing, the broker shall be deemed to be aware of any facts or statements contained in the notice required by paragraph (h)

of this section.

Jefferies conceded to have made none of the inquiries required by Rule 144(g)(3) and offered no evidence at trial that it had examined Duntov's Rule 144 statement or was aware that the latter had even filed the requisite statement before soliciting sales orders from NAEC. Accordingly, the evidence was undisputed that Jefferies was not entitled to an exemption from the strict liability provisions of Sections 5b(2) and 12(1).

As a non-exempt statutory underwriter selling the covered EFCA securities for a controlled subsidiary and controlling person of the issuer (EFCA), respondent became fully exposed to the strict liability provisions of Sections 5b(2) and 12(1) of the 33 Act. To date, the only circuit to affirm a

broker's requirements incident to obtaining a broker's exemption is United States v. Wolfson, 405 F.2d 779, 781 (2d Cir.), cert. denied, 394 U.S. 946 (1968). But Wolfson involved the construction of Rule 154, which was superceded by Rule 144 in 1972. The requirements of Rule 144 fall with equal impact on brokers seeking an exemption and need only some reaffirmation by the federal courts.

For sure, some confusion now exists among the circuits as to the life and scope of the Manor Nursing doctrine. This Court has never had occasion to pass judgment on the availability of the strict liability provisions of Section 12(1) for ultimate purchasers of publicly traded shares covered by registration statements and prospectuses

of "sham" quality. The Equity Funding vehicle provides the best possible opportunity to settle this question for the lower courts, since it represents the ultimate in major fraud cases. The fraudulent character of its SEC filings are without dispute, and the notoriety of the entity is probably without parallel.

5. The decision below conflicts with the decisions of other circuits and raises important questions concerning the burden of proof that should be shouldered by sellers of securities covered by fraudulent prospectuses to avoid liability under the 1933 Securities Act.

This case also raises serious questions regarding the scope of the duties imposed on sellers of securities covered by fraudulent prospectuses. Section 12(2) fixes a burden of proof on sellers of securities covered by

prospectuses which contain material misrepresentations the burden of proof of demonstrating that they didn't know of the misrepresentations and in the exercise of reasonable care could not have learned of the same. Does this burden require a selling broker (such as Jefferies here) to make some diligent inquiries before selling shares covered by a fraudulent prospectus with assured impugnity? Section 12(2) states manifestly in the affirmative.

The record facts established at trial leave undisputed that respondent sold Duntov's EFCA shares (a) upon orders placed by North American and (b) without making any inquiries as to the identity of the former's customer and the existence of any disabilities the customer might have in selling his EFCA

shares in the public trading markets. It is equally established that the price of EFCA stock had dropped precipitously in the weeks preceding the March 26th trades from $27 a share to $17. See Dirks v. SEC, supra and decision of court below (Appendix B). Storm warnings were ever present on the fateful March 26th trade day, when Jefferies accepted North American's sale orders without question.

The statutory history of Section 12(2) confirms a Congressional intention of allocating the risks of loss between innocent buyers and sellers better equipped to make reasoned inquiries before transmitting sale orders to the public trading markets. See S. Rep. No. 47, 73rd Cong., 1st Sess. 5 (1933). For certain, the burden of proof requirement

imposed on sellers seeking avoidance of Section 12(2) liability manifests a congressional scheme designed to ensure maximum seller diligence. This is most apparent from the Senate Report accompanying the 33 Act, which recites in pertinent part as follows:

> If one of two presumably innocent persons must bear a loss, it is (sic) familiar legal principle that he should bear it who has the opportunity to learn the truth and has allowed untruths to be relied on. S. Rep. No. 47, supra, at 5.

The House Report follows suit in making clear the Congressional intent to shift the burden to the seller to demonstrate due diligence in ascertaining faulty statements in prospectuses covering shares placed for public sale. See H. Rep. No. 85, 73rd

Cong., 1st Sess. 9-10 (1933). According to the House Report:

> Unless responsibility is to involve merely paper liability, it is necessary to throw the burden of disproving responsibility for reprehensible acts of omission or commission on those who issue statements for the public reliance. The responsibility is no more nor less than that of a trust. H. Rep. No. 85, supra, at 9-10.

In the 50-year history of the 33 Act, there have been only a few cases that have addressed a selling underwriter's Section 12(2) burden of showing reasonable care as a defense of sales covered by fraudulent prospectuses (as here). And in each of these cases, the courts have consistently confirmed the statutory requirement of the underwriter's being required to make some inquiry to avoid liability. Cf.

Alton Box Board Co. v. Goldman, Sachs, 560 F.2d 916, 922 (8th Cir. 1977); Franklin Savings Bank v. Levy, 551 F.2d 521, 527 (2d Cir. 1977); University Hill Foundation v. Goldman, Sachs, 422 F. Supp. 879, 904 (SDNY 1976).

While all of the Goldman, Sachs' cases involved sellers who were undisputed underwriters marketing securities, the statutory test furnished in Section 2(11) of the 33 Act covers brokers who sell for controlled and controlling persons of an issuer. To be sure, even the Section 4(4) brokers' exemption would not insulate a broker from the anti-fraud provisions of Section 12(2), where the broker is shown (as here) to be "uniquely positioned to ask relevant questions, acquire material information, or disclose his findings."

Wasson v. SEC, 558 F.2d 879,886-87 (8th Cir. 1977) (cited by the lower court). And the record is clear in any case that respondent did not make the requisite inquiries to satisfy Rule 144(g)(3).

Respondent's principal Section 12(2) defense below was that it was entitled to rely on public information available at the time it executed its subject trades. The argument is fatally defective for two crucial reasons: (1) Respondent was constructively armed with market information of plummeting EFCA stock prices and the identity of at least NAEC as a controlled subsidiary of EFCA and (2) a selling broker is under a statutory duty to exercise reasonable care to immunize itself from the strictures of Section 12(2). As the Seventh Circuit held in Sanders v. John

Nuveen & Co., Inc., 524 F.2d 1064, 1069-71 (7th Cir. 1975)(Sanders II), cert. denied in Sanders IV, 619 F.2d 1222, 450 U.S. 1005 (1981), a broker/underwriter may not avoid its Section 12(2) burdens by a simple showing that it was not in a position to make an effective inquiry. Underscored by Judge Stevens in Sanders II was the notation that:

> The underwriter is under a duty to make at least some investigation directed at the question whether the ever present possibility of fraud is in fact a reality. Id., at 1071.

The depth of Jefferies' inquiry responsibilities, given the information at its disposal, is admittedly a question dependent upon the peculiar circumstances of Jefferies' trading

position on the day of trade. But clearly some inquiry was required of Jefferies to escape Section 12(2) liability.

Supreme Court review of Sanders IV might have provided some clarity to Section 12(2) reasonable care burdens, but this Court declined a review of Sanders IV. We must draw the Court's attention, though, to a strong dissent registered by Justice Powell (joined by Justice Rehnquist). See id., at 1006-11. Justice Powell observed that the Sanders II decision appeared "to impose a duty of investigation rather than Section 12(2)'s requirement of reasonable care." Id., at 1008-11. Justice Powell, in turn, expressed the belief that Section 12(2)'s standard was less demanding than Section 11 of the 33

Act and does not, as such, require investigation in every trading case. Id. He would have granted certiorari in Sanders IV to clear up potential confusion in the statutory tests of Sections 11 and 12(2) of the 33 Act. We agree that Section 12(2) is ripe for statutory construction, if only to establish definitive minimal standards of care for selling brokers dealing in bum stock transactions with controlled and controlling persons of issuers.

To clarify Section 12(2) reasonable care standards few cases provide a better factual scheme for review. The storm warnings available to Jefferies on March 26, 1973 were notable as we have outlined (viz., Jefferies' known relationship of NAEC and EFCA, Duntov's identity being known to the president

and general counsel of respondent and the public information of EFCA's plummeting stock prices in the preceding two weeks before the March 26th Duntov trades). Under the circumstances, Jefferies conceded failure to make the most rudimentary inquiries defy even minimal claims to reasonable care under Section 12(2). We think that the duties of a selling broker are much too clear under the controlling legislation and case authorities to draw a bead of dissent as to the need of minimal inquiries. But this Court's supervisory powers are called into play to neutralize lower court departures from accepted standards and clarify in a definitive way the tests for meeting Section 12(2) burdens.

CONCLUSION

For the various reasons, the petition for certiorari should be granted, to the end of reversing the lower courts and holding Jefferies liable to petitioners and their class of purchasers on the latters' interpleader claims, or in the alternative on the claims of liability under Sections 12(1) and 12(2) of the 1933 Securities Act, and remanding the case for proceedings consistent with a determination of liability.

Respectfully submitted,

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APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 83-1833

Jefferies & Company, Inc.,
Appellee,

United Missouri Bank of Kansas City, N.A., et al,

v.

A.W. Jones Company, Milton Phillips, Trustee for Milton Phillips Pension Trust, Individually and on behalf of all others similarly situated,

Appellants.

Submitted: March 13, 1984

Filed: August 29, 1984

Before ROSS, Circuit Judge, HENLEY, Senior Circuit Judge, and BOWMAN, Circuit Judge.

PER CURIAM.

Appellants seek to overturn a decision of the District Court[1] denying them any right to an alleged interpleader fund created by the appellee. The underlying facts are set out in the memorandum opinion of the District Court and will not be repeated here.

The District Court found in favor of appellee on the interpleader issue because "no surplus fund for interpleader ever existed in fact." D.R. at 336. It also concluded that appellants had waived any substantive claims against appellee.

We have carefully considered the record, the briefs, and the arguments of the parties in this

case. We conclude that the judgment of the District Court is based on findings of fact that are not clearly erroneous and that no error of law appears. Accordingly, the judgment of the District Court is affirmed. See 8th Cir. R.14.

A true copy.

Attest:

CLERK, U.S. COURT OF APPEALS,
EIGHTH CIRCUIT.

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[1]The Honorable Howard F. Sachs, United States District Judge, Western District of Missouri.

APPENDIX B

IN THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF MISSOURI WESTERN DIVISION

NO. 74-CV-115-W-2-6

JEFFERIES & COMPANY, INC.
Plaintiff,

v.

UNITED MISSOURI BANK OF KANSAS CITY OF KANSAS CITY, N.A., et al.,
Defendants.

No. 79-0023-CV-W-2-6

JEFFERIES & COMPANY, INC.,
Plaintiff,

v.

YURA ARKUS-DUNTOV, et al.,
Defendants.

MEMORANDUM OPINION AND ORDER DIRECTING ENTRY OF JUDGMENT

This litigation involves a multiplicity of claims arising out of the sale, by an insider, of stock in the Equit. Funding Corporation of America (EFCA) on the eve of halting of trading in that company's stock. Most of the claims in this suit have been settled. Trial of claims by a class of ultimate purchasers, the Jones/Phillips class (Jones/Phillips), against plaintiff Jefferies & Co. and defendant United Missouri Bank (UMB) was had to the Court in June of 1982. Ruling has been reserved on these claims pending approval of a settlement between Jones/Phillips and defendants Shearson/American Express (Shearson), North American Equity Corporation

(NAEC), and the estate of Yura Arkus-Duntov (Duntov). At this time, we find against the class and for Jefferies and UMB on the remaining claims.

FACTS

The Court adopts the following findings of fact, which have been stipulated to by the parties or are not challenged by the opposing party:

(1) Paragraphs 1-45 of section III of the pretrial conference order dated September 1, 1978;

(2) Paragraphs 1-22 of findings of fact entered October 20, 1976 in M.D.L. No. 142, the multi-district proceeding entitled In re Equity Funding Corporation of America Securities Litigation;

(3) Paragraphs 1-22, 23 and 25 of Jefferies' proposed findings of fact, filed July 7, 1982;

(4) Paragraphs 1-7, 10, 16-19, 22, 24-26, 34, 39 and 42 of UMB's proposed findings of fact, filed July 12, 1982.

In addition, the Court adopts the following proposed findings of fact submitted by the parties:

(1) Paragraphs 22, 24 and 26-35 of Jefferies' proposed findings of fact, filed July 7, 1982;

(2) Paragraphs 9, 12-15, 20, 21, 23, 27, 30, 33, 38, 40, 41 and 43 of UMB's proposed findings of fact, filed July 12, 1982;

(3) Paragraphs 3, 5, 7, 9-18, 20, 23, 24, 26, 31 and 33 of Jones/Phillips' proposed findings of fact, filed July 19, 1982.

Additional findings are made in the course of the discussion that follows. Most of the facts are essentially undisputed. The only serious dispute relates to what information UMB had concerning problems at EFCA and when it obtained such information. In their original contentions, as reflected in their resubmission of contentions filed March 10, 1982, Jones/Phillips contended that UMB was aware of improperties at EFCA as of March 26, 1973. There was no evidence presented to support this contention and post-trial briefing indicates that it has been abandoned. UMB contends that it did not learn anything suspicious regarding EFCA until the afternoon of April 2, 1973, after the transaction had been closed and the bank had received a check from

Jefferies. Jones/Phillips contends that the bank learned of problems on March 29, the day that the Wall Street Journal reported that trading in EFCA common stock had been suspended.

The evidence established that the bank was not aware of problems at EFCA prior to April 2d. William Bolt, who was then chairman of the bank's executive committee, testified that he did not see the March 29 Wall Street Journal article and that he first learned of problems on April 2d at about 2:00 to 2:15 Kansas City time when Theodore Chapman, a trust officer at the bank, related a conversation he had had with Lawrence Williams of NAEC, in which Williams had informed Chapman of the suspension of trading and of an April 2d Wall Street Journal article. The

purpose of Williams' call related to a separate transaction involving Stanley Goldblum, EFCA's chairman, and not to the Duntov sale. Although there is no indication how much earlier Chapman's conversation with Williams preceded his conversation to Bolt rather promptly, given that Williams had requested that the bank stop payment on certain checks cashed by Goldblum.[1]

SUMMARY OF FACTS

From sometime prior to 1969 until March 1973, a massive fraud was perpetrated by certain officers and directors of Equity Funding Corporation of America (EFCA) and its subsidiary, Equity Funding Life Insurance Company (EFLIC). The nature of the fraud need

not be explored in detail. Essentially, it involved issuing bogus life insurance policies, obtaining cash through reinsuring those policies with other insurers, and obtaining proceeds through filing false claims with the reinsurers. EFCA's financial records falsely reflected an overstatement of income and assets and an understatement of liabilities as a result of these transactions and other fraudulent conduct.

In early March of 1973, an investment analyst named Raymond Dirks was told (by a former employee of an EFCA subsidiary) about the scheme at Equity Funding. Dirks investigated and confirmed the story, through what one court has described as "two weeks of

concentrated effort, at times resembling something from detective fiction." Dirks v. S.E.C., 681 F.2d 824, 828 (D.C.Cir.), cert. granted, 103 S.Ct. 371 (1982). Dirks dislclosed what he learned to customers, rumors began to circulate and the price of Equity Funding stock began to drop. In addition, on March 12, 1973, the Illinois Insurance Department began a surprise audit of EFLIC. On March 27, 1973, the New York Stock Exchange halted trading in EFCA common stock, and, on March 28, halted trading in all EFCA securities.[2]

Yura Arkus-Duntov, an employee of EFCA since April, 1966, was the president of EFC Management Corp., a wholly owned subsidiary of EFCA, at the

time of the events in issue. He was also a director of EFC Management and of EFCA, and a member of EFCA's executive committee. Duntov had a loan with defendant UMB, which had a $210,000 balance owing and was secured by EFCA common stock. He had an additional loan with Franklin National Bank, also secured by EFCA common stock. Prior to March 26, Duntov had learned of the Dirks rumors and had discussed them with officials of EFCA. Duntov stated in his deposition that these individuals denied that the rumors were accurate. Duntov also learned of the Illinois Insurance Department audit prior to March 26. On the morning of March 26, Duntov initiated sales of all of the 11,475 shares of stocks securing the Franklin loan and 13,000 of the shares securing

the UMB loan, an amount sufficient to pay off the loan. Duntov called his secretary, Maria Janesch, from the office of Lawrence Williams, an officer of NAEC, and told her to make the sales.

The Franklin sale was accomplished by Janesh placing the order to sell directly with Stan Short of NAEC. NAEC was a broker that was also a subsidiary of EFCA under Duntov's supervision. With respect to the UMB shares, Janesch called the bank, inquired as to the number of shares needed to be sold to close out Duntov's loan, and requested that the bank call NAEC to place the order. The bank requested that the instructions come directly from Duntov, whereupon he called back and requested that the sale be made. A confirming wire was sent later. Subsequently,

Byron McReynolds, a junior loan officer at the bank, called Stan Short at NAEC and directed that 13,000 shares be sold. It is uncertain whether McReynolds told Short whether the shares being sold were Duntov's. It is undisputed that at the time the trade was made, UMB had no knowledge of the Dirks rumors or of improprieties at Equity Funding. Short called Jefferies to execute the sale of both blocks of stock. Jefferies was a member of the New York Stock Exchange, while NAEC was not. Short did not advise Jefferies, and Jefferies did not inquire of Short, or the identity of the seller. The evidence established that it was standard practice for the identities of customers not be disclosed, in order to avoid higher

brokerage fees charged on aggregated trades.

Jefferies sold Duntov's shares on the New York Stock Exchange on March 26, at prices ranging from 16-1/2 and 17-3/8. Settlement of the trades was on April 2. At the settlement UMB and Franklin presented certificates for the 24,475 shares traded. In exchange, Jefferies delivered two checks drawn on its account at Chase Manhattan Bank. One check, in the amount of $192,256.35 was made out to Duntov. The second check, in the amount of $217,448.08, was made out to UMB. John Muscara, the head of Jefferies' New York office, saw that the name on the certificates was that on Duntov. Muscara did not know who Duntov was, but called Monte Krissman, executive vice-president of Jefferies,

pursuant to instructions to notify Krissman of settlements in Equity Funding trades. Krissman knew that Duntov was an officer and director. This was the first point at which Jefferies learned that the trade had been on behalf of an EFCA insider. Muscara unsuccessfully attempted to catch the messenger who had delivered the certificates and received the checks. Jefferies attempted to stop payment on the checks, but Chase refused. Jefferies then filed this lawsuit[3] and obtained a temporary restraining order enjoining payment of the two checks. Upon Jefferies' motion for a preliminary injunction, Judge Gurfein enjoined payment of the check to Duntov but refused to enjoin payment of

the check to UMB. 357 F. Supp. 1206 (S.D.N.Y. 1973).

Jefferies encountered difficulties in settling the transaction with "downstream" brokers representing buyers on April 2. In particular, Hayden Stone (subsequently appearing in this litigation as Shearson, Hayden Stone and Shearson/American Express), which had been directed by the Stock Clearing Corporation to accept 19,300 of the 24,475 shares and pay Jefferies $328,100, refused to complete the trade. Steiner, Rouse also refused to settle a $3400 amount. Ultimately, in December, 1976, Jefferies settled with Shearson for $151,739.65, an amount that made Jefferies whole with the exception of certain minor expenses.

CLAIMS AGAINST JEFFERIES

Jones/Phillips' claim against Jefferies is based on Jefferies having filed an interpleader count in the amended complaint, filed in New York, May 8, 1973.[4] Jones/Phillips contends that Jefferies interplead a fund consisting of $192,256.35 for the benefit of ultimate purchasers of shares sold by Duntov and that the class is entitled to that fund. The short answer to Jones/Phillips' claim is that the anticipated fund never came into existence. As of April 12, 1973, when Judge Gurfein enjoined payment of the $192,000 certified check to Duntov, Jefferies anticipated that, upon completion of the settlement of the transactions, it would have a surplus in that amount. Jefferies was simply an

intermediary broker, a middleman. It was to have received approximately $409,000 from settling brokers and, in turn, paid the same amount to Duntov and UMB. Upon the enjoining of payment of the check to Duntov, a surplus in the amount of that check could be anticipated. In fact, however, two of the settling brokers, Hayden Stone and Steiner, Rouse, refused to settle transactions in the amount of $328,100 and $3400, respectively. This left Jefferies out of pocket rather than having a surplus. Ultimately, Jefferies settled with Shearson, the successor of Hayden Stone, for an amount at which Jefferies broke even, except for some minor expenses. Thus, no surplus fund available for interpleader ever existed in fact. For the reason, judgment on

Jones/Phillips' claim against Jefferies must be entered in favor of Jefferies.[5]

CLAIMS AGAINST UNITED MISSOURI BANK

Jones/Phillips has stated claims against UMB based on sections 12 and 17 of the Securities Act of 1933, 15 U.S.C. sections 771 77q, section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. section 78j and Rule 10b-5 promulgated thereunder, common law fraud, and section 8-306 of the Uniform Commercial Code, section 400.8-306, R.S.Mo. We address each of these claims in turn.

SECTION 12 CLAIMS

The provisions of section 12 of the Securities Act apply to "Any person who offers or sells a security." The initial inquiry to be made, therefore,

is whether UMB may be considered a seller for purposes of this section. In Wasson v. SEC, 558 F.2d 879 (8th Cir. 1977), the Eighth Circuit reviewed the two primary tests enunciated for determining whether an individual is a seller for purposes of section 2(3) of the '33 Act, the relevant definitional section. These two tests may be referred to as the participation test, see Wonneman v. Stratford Securities Co., Inc., CCH Fed.Sec.L.Rep. Paragraph 90,923 (S.D.N.Y. 1959), and the proximate cause test, see Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680 (5th Cir. 1971). The court rejected the participation test, which "would hold liable virtually every person who participated in the events leading up to the transaction," as "too

broad in that it extends liability to persons for remote or incidental connection with the transaction." 558 F.2d at 885-86. The court also declined to adopt the proximate cause test, which it viewed as placing insufficient emphasis on the Securities Act's policy of providing investors with enclosure of material information. Id. at 886. Wasson upheld an order of the SEC temporarily suspending a broker from associating with brokers and dealers. In holding that the broker could be considered a seller, the court stated that one factor to be considered was "whether the defendant was uniquely positioned to ask relevant questions, acquire material information, or disclose his findings." id., and relied on Wasson's "extensive role in

facilitating the sale," his awareness "of questionable circumstances surrounding the transaction which should have been investigated more fully" and "his position in the flow of information." Id. at 886-87.

Although UMB could arguably be regarded as being "positioned to ask relevant questions," we believe the bank's involvement with the transaction in issue was essentially the type of incidental involvement of which the Wasson court spoke in disapproving the participation test. The bank's involvement consisted of determining the number of shares required to be sold to pay off Duntov's loan and relaying the message from Duntov and Janesch to sell that number of shares. Unlike Wasson, UMB's role can hardly be regarded as

"extensive." Nor was the bank aware of questionable circumstances alerting it to investigate further before relaying the sale message. No one at UMB was a broker, obligated to "investigate more fully" and to reveal findings "in detail to his superiors." While we conclude that the bank was something more than an intermediary, under the Uniform Commercial Code (See discussion of Section 8-306 claim, infra), the bank should not be regarded as a seller for purposes of section 12 liability.[6] In common law terms the bank was an (innocent) agent coupled with an interest.

Even if UMB were considered a seller, additional grounds preclude recovery under section 12. With respect to Jones/Phillips' claim that the shares

were not registered, the evidence established that the registration requirements of the Act were satisfied. UMB Exh. J, K; J/P Exh. O. Jones/Phillips contends that the registration statement and prospectus for EFCA contained such massive misstatements that the registration should be considered a sham and "a nullity ab initio" Jones/Phillips July 19, 1982 suggestions at 17. No support is offered for this proposition, however. The argument is analogous to Jones/Phillips' argument, relying on the case of SEC v. Manor Nursing, 458 F.2d 1082 (2d Cir. 1972), that UMB was required to deliver a current and accurate prospectus. Manor Nursing discussed, in the context of an SEC enforcement action, the prospectus

delivery requirement of section 5(b)(2) of the 33 Act, 15 U.S.C. section 77e(b)(2), and held that "implicit in the statutory provision that the prospectus contain certain information is the requirement that such information be true and correct." 458 F.2d at 1098. Although this proposition does not appear upon first impression to be unreasonable and a literal reading of section 12(1) would incorporate section 5(b)(2), Manor Nursing has been extensively criticized, see SEC v. Southwest Coal & Energy Co., 624 F2.d 1312, 1318-19 (5th Cir. 1980) (citing 2 A. Bromberg & Lowenfels, Securities Fraud and Commodities Fraud, section 6.11 (321) (1979); Comment, Truth Up to the Date of Use as a Requirement for a Section 10(a) Prospectus: The

Implications of SEC v. Manor Nursing Centers, Inc., 24 Case W.Res.L.Rev. 771 (1973); 71 Mich.L.Rev. 591 (1973), and the case has never been relied on to create liability under section 12(1). The primary reason for the criticism springs from the proposition that the securities laws were enacted to serve two distinct goals, disclosure and fraud prevention, with discrete statutory provisions and mechanisms designed to accomplish each of these goals. Southwest Coal, supra, at 1318; Byrnes v. Faulkner, Dawkins & Sullivan, 413 F. Supp. 453, 465-66 (S.D.N.Y. 1976), aff'd, 550 F.2d 1303 (2d Cir. 1977). Section 12(1) deals with the first goal, disclosure. It is a strict liability provision. Southwest Coal,supra, at 1318. To allow the section to be used

to impose liability for misrepresentation would be to eliminate the availability of the defenses provided by other sections, such as section 12(2), which are concerned with fraud prevention. Id. at 1318-19; Byrnes, supra, at 465. We decline to follow Manor Nursing to impose strict liability under section 12(1) for misrepresentation in the registration statement or the prospectus.

Analysis of the claims against UMB under section 12(2), assuming arguendo that UMB is considered a seller, does not dictate a finding of liability. Section 12(2) provides for liability upon the making of an untrue statement of a material fact or the omission to state a material fact, unless the defendant establishes "that he did not

know, and in the exercise of reasonable care could not have known, of such untruth or omission." In analyzing the question of liability under this section, we must determine the relevant time at which omissions may create liability. Jones/Phillips contends that the bank had a continuing duty to investigate and disclose up to April 2, 1973, the closing date, the date traded shares and checks were exchanged. UMB contends that the relevant date is March 26, 1973, the date on which the trade was made. We adopt UMB's position, relying on Radiation Dynamics, Inc. v. Goldmuntz, 464 F.2d 876 (2d Cir. 1972). Radiation Dynamics held that

> the time of a "purchase or sale" of securities within the meaning of Rule 10b-5 is to be determined as the

> time when the parties to the transaction are committed to one another. A party does not, within the intendment of Rule 10b-5, use material inside information unfairly when he fulfills contractual commitments which were incurred by him for . . . the Rule imposes "no obligation to pull back from a commitment previously made by the buyer and accepted by the seller because of after acquired knowledge."

Id. at 891 (quoting jury instruction). Accord The Toledo Trust Co. v. Nye, 588 F.2d 202 (6th Cir. 1978); Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033 , 1050 (7th Cir. 1977), cert. denied, 434 U.S. 875 (1978); Bolton v. Gramlich, 540 F. Supp. 822, 839 (S.D.N.Y. 1982). Cf. St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 562 F.2d 1040 (8th Cir. 1977) (loss not caused by omission

of material fact when obligation to sell arose prior to occurrence of the fact not disclosed), cert. denied, 435 U.S. 925 (1978). The same analysis should apply to the anti-fraud provision of section 12(2).

Jones/Phillips cites several cases in favor of the proposition that the closing date is the relevant date. These are, for the most part, not supportive of Jones/Phillips' position. Metro-Goldwyn-Mayer, Inc. v. Ross, 509 F.2d 930 (2d Cir. 1975) looked to the closing date, but specifically stated that it did so due to a provision in the agreement for the sale of the stock adopting the closing date. Id. at 934. In SEC v. National Student Marketing, 457 F. Supp. 682 (D.D.C. 1978), the agreement provided that the obligation

to proceed was subject to certain conditions, so that the date of commitment occurred later than the date of the agreement. The court relied on and applied the analysis of Radiation Dynamics. Goodman v. Epstein, 582 F.2d 388 (7th Cir. 1978), cert. denied, 440 U.S. 939 (1979) held that in a case involving a series of investment decisions as part of a continuing relationship, as distinguished from a "one-shot deal," the point at which each such decision is made is the relevant date. While Goodman may be viewed as distinguishing Radiation Dynamics, the two cases are consistent in that each looks to the point at which the parties are committed with respect to a particular transaction. In any event, the instant case was a "one-shot deal"

within the meaning of Goodman. The most troublesome case cited by Jones/Phillips is Aronson v. TPO Inc., 410 F. Supp. 1375 (S.D.N.Y. 1976). The reasoning of the case is confusing, as reflected by the fact that both parties contend that it supports their position. In fixing the relevant date, Aronson cites Radiation Dynamics and another case holding that "the date the contract of sale was signed" governs, Thomas v. Duralite Co., Inc. 386 F. Supp. 698, 716 (D.N.J. 1974) but cites these cases for the proposition that the date of closing is the date of sale. Aronson has not since been cited for this point and does not appear to be sound authority as to determining the date of sale. We hold that the date of the agreement or trade, March 26 in this case, governs.[7]

Having determined that March 26 is the relevant date for judging the bank's conduct, it is a short step to deciding that the bank did not violate section 12(2), even if it could be regarded as a seller. It is undisputed that as of March 26, UMB was not aware of the Dirks rumors or of any other information concerning wrongdoing at EFCA. Jones/Phillips appears to argue that UMB should be held liable because it did not disclose the identity of its customer to NAEC and because it did not inquire of Duntov whether he had a right to sell the shares. Liability cannot be imposed for the failure to inform NAEC of Duntov's identity, if indeed McReynolds failed to so inform NAEC. NAEC was aware that Duntov was selling his shares on March 26 and would not have disclosed

his identity to Jefferies in any case, due to industry practice. Nor would Jefferies have inquired as to the seller's identity. Under these circumstances, causation of any damages as a result of the failure to disclose Duntov's identity is lacking. Jones/Phillips' other contention seeks to impose a duty on institutions acting as custodians of shares owned by corporate insiders to conduct an investigation of the corporation any time the insider decides to sell shares. No support is offered for this argument. The simple fact that Duntov told UMB that he wished to pay off his loan through selling a sufficient number of shares, absent additional knowledge of rumors or improprieties on March 26, is insufficient to rebut the bank's showing

that it exercised reasonable care in facilitating the transaction.

SECTION 17 CLAIM

Under the law of this Circuit, liability under section 12 is a prerequisite to a cause of action based on section 17 of the '33 Act. Greater Iowa Corp. v. McLendon, 378 F.2d 783, 790 (8th Cir. 1967); In re Falstaff Brewing Corp. Antitrust Litigation, 441 F. Supp. 62, 67 (E.D.Mo. 1977). Having found no violation of section 12, we need not further consider the claim under section 17.

SECTION 10(B) AND COMMON LAW FRAUD CLAIMS

Resolution of the section 12(2) claim is basically dispositive of the section 10(b) and common law fraud claims as well. Under Radiation

Dynamics, supra, the bank's conduct is to be examined as of March 26. As of that date, the bank was aware of no information concerning improprieties at Equity Funding. The fact that it did not balk at processing the sale simply because the seller was an officer of a subsidiary of the company whose shares were being sold cannot be viewed as reckless conduct so as to trigger the scienter requirement of section 10(b) and Rule 10b-5. The elements of an action for common-law fraud in Missouri are a material false representation, the speaker's knowledge of its falsity or ignorance of its truth, his intent that it should be acted upon by the hearer in the manner reasonably contemplated, the hearer's ignorance of its falsity, his reliance on its truth, his right to rely

thereon, and consequent and proximate damage to him. Slater v. KFC Corp., 621 F.2d 932, 936 (8th Cir. 1980). The evidence established no materially false representations made with UMB's knowledge of falsity or ignorance of truth. The fraud claim must also fail.

SECTION 8-306 CLAIM

Jones/Phillips' final claim is that the bank breached the transfer warranties imposed by section 8-306 of the Uniform Commercial Code. UMB defends against this count by arguing that, as a pledgee, it made only the warranties of an intermediary, i.e., that it was acting in good faith and had authority to make the transfer. Section 400.8-306(3), R.S.Mo. The bank's status as a pledgee is evident. That does not end the inquiry, however. A pledgee

must satisfy one of two additional conditions to limit its warranties to those made by an intermediary. The pledgee must be either redelivering the security to the debtor or delivering the security to another after payment and on order of the debtor. Section 400.8-306(4) R.S.Mo.; First National Bank in Grand Prairie v. H. Hentz & Co., Inc. 498 S.W.2d 478, 482 (Tex. Civ. App. 1973). Neither of these conditions is satisfied in this case.

Having failed to qualify as an intermediary, UMB will be held to have made the warranties included in section 400.8-306(2). These included warranties that (a) its transfer was effective and rightful (b) the security was genuine and had not been materially altered, and (c) it knew of no fact which might

impair the validity of the security. Jones/Phillips relies only on the last section. Jones/Phillips' July 9, 1982 suggestions at 49.[8] The evidence did not establish that the bank knew of improprieties at EFCA, however, let alone that it knew of anything impairing the intrinsic validity of the security. Accordingly, we find for the bank on this claim.

For the reasons stated above, it is hereby

ORDERED that judgment on claims of the Jones/Phillips class against Jefferies and United Missouri Bank be entered in favor of Jefferies and United Missouri Bank. Costs of those parties in defending the claims are to be assessed against Jones/Phillips.

-S-

HOWARD F. SACHS
UNITED STATES DISTRICT
JUDGE

DATED: May 24, 1983

APPENDIX B

FOOTNOTES

[1]. Jones/Phillips filed a motion to reopen the record after trial to offer deposition designations regarding this issue. The motion was denied. Nevertheless, the Court has examined these designations and determined that they would not warrant concluding that the bank was aware of problems prior to April 2d. Chapman, in his deposition, did not recall learning of any problems prior to April 2d. Williams expressed some uncertainty as to whether his conversation with Chapman had taken place on March 30 or April 2, but ultimately decided it had occurred on April 2.

[2]. It is apparent that the halt to "trading" stops the formation of new sales contracts and does not prohibit the consummation of prior sales agreements.

[3]. The suit was actually filed twice. Suite was originally filed in the Southern District of New York, on April 2, 1973. The case was transferred to the Court in 1979, after Multi-District processing. Subsequently, in 1974, a nearly identical action was filed in this district, due to concern over whether venue over UMB was proper in New York.

[4]. At trial, Jones/Phillips also appeared to argue that it was pursuing

substantive claims against Jefferies. No intimation of such claims was contained in the September 1, 1978 pretrial conference order or in the March 10, 1982 resubmission of pretrial legal contentions. Furthermore, at the commencement of trial, counsel for Jones/Phillips stated that "(w)w have never made any claim to anything other than that $192,000.00. At this point there is no adversary relationship between Jefferies and the Class." Tr. 22. Any substantive claims by Jones/Phillips against Jefferies have been waived.

5. It is claimed that Jefferies is estopped to alter a judicial admission in New York that it holds a fund. The so-called continuing admission was not carried over into the companion litigation initiated in this Court, and Jefferies successfully resisted a motion in late 1979 for deposit of funds, asserting there was no fund to be deposited. While an amendment of pleadings might have been appropriate, Jefferies' position has been fully disclosed since 1979 and the facts will not permit judgment against Jefferies.

6. Jones/Phillips has also argued at various points and on various claims that UMB may be liable as an aider and abettor of Duntov. The elements of aider and abettor liability are the violation of the Act by the primary party, the alleged aider's knowledge of the violation, and knowing and substantial assistance by the alleged

aider in the achievement of the primary violation. Cleary v. Perfectune, 700 F.2d 774, 777 (1st Cir. 1983); Armstrong v. McAlpin, 699 F.2d 79, 91 (2d Cir. 1983); Stokes v. Lokken, 664 F.2d 779, 782-83 (8th Cir. 1981). While the first element is apparently satisfied in this case, there has been no showing that UMB knew of the violation, or that its involvement was substantial.

7. Even if we were to look to the time of the closing, UMB would not be liable in light of our finding that UMB did not learn of the problems at EFCA until later in the afternoon of April 2d.

8. It could be argued, though it is not, that the bank's transfer was not "rightful." Little authority has been located construing this provision. Morgan Guaranty Trust Co. v. New England Merchants National Bank, 438 F. Supp. 97 (D. Mass. 1977) states that "fraud, incapacity, duress and lack of authority are examples of circumstances which might render a transfer wrongful." Id. at 101. None of these circumstances apply to UMB's actions in this case. Whatever the limits of this section, it would be extraordinary to construe it to incorporate all concepts of vulnerability or voidability under the federal securities laws, based on the possibility of misconduct by the debtor.

APPENDIX C

IN THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF MISSOURI WESTERN DIVISION

In re Equity Funding Corporation of America Securities Litigation

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Civil No. 79-0023-CV-W-2-6

JEFFERIES & COMPANY, INC.,
Plaintiff,

v.

YURA ARKUS-DUNTOV, et al.,
Defendants.

Civil No. 74-CV-115-W-2-6

JEFFERIES & COMPANY, INC.,
Plaintiff,

v.

UNITED MISSOURI BANK OF KANSAS CITY, N.A., et al.,
Defendants.

A.W. JONES COMPANY; MILTON PHILLIPS, Trustee for Milton Phillips Pension Trust, Individually and on behalf of all others similarly situated,

Cross-Complainants,

v.

YURA ARKUS-DUNTOV; UNITED MISSOURI BANK OF KANSAS CITY, N.A.; NORTH AMERICAN EQUITY CORPORATION: SHEARSON HAYDEN STONE, INC.,

Cross-Defendants.

MEMORANDUM AND ORDER OVERRULING MOTION TO REQUIRE INTERPLEADER OF FUNDS

By argument and affidavit filed October 4, 1979, plaintiff (Jefferies) denies the existence of a fund which should be paid into the Registry of this Court, and further denies that in any currently-applicable pleading it has offered to pay such sum for the benefit of various purchasers of stock who are

the ultimate claimants in this litigation (hereinafter referred to as the Jones claimants).

The Jefferies response does not deal with issues of ultimate liability, because not presented by the Jones motion, and the Court expresses no view as to whether Jefferies may ultimately be liable to the Jones claimants to disgorge sums (with interest) which it has apparently used to recoup its losses.

Reply suggestions were tendered by the Jones claimants, dated October 20,1979. The most direct response to Jefferies was by contention on page 8 that "a bill in the nature of interpleader" is proper even though "plaintiff reserves a right to the fund or property." Walmac Company v. Isaacs,

220 F.2d 108, 112 (1st Cir. 1955). But we do not find authority which would support the Court in ordering such an interpleader plaintiff to deposit funds pending litigation, when it claimed the funds as a matter of right.

The Jones claimants further aver that Jefferies is taking a position not presented in its initial pleading. If so, the pleadings should normally be amended to conform to the current contentions of the parties. Whether Jefferies should be barred from amending, because of long delay after filing its initial pleading, or because of proceedings before Judge Lucas, are questions reserved for consideration when and if Jefferies seeks to amend.

In the absence of citation of authority to the contrary, the Court

does not find any basis for an interlocutory order forcing Jefferies to deposit funds which it now claims. Without prejudice to claims and contentions not here ruled, it is therefore

ORDERED that the Motion for Order of Interpleader is hereby overruled.

-S-
UNITED STATES DISTRICT JUDGE

Kansas City, Missouri

DATED: November 7, 1979.

APPENDIX D

JEFFERIES & COMPANY, INC.,
Plaintiff,

v.

Yura ARKUS-DUNTOV et al.,
Defendants.

No. 73 Civ. 1407 (MIG).

United States District Court,
S.D. New York.
April 12, 1973.

GURFEIN, District Judge.

Plaintiff ("Jefferies"), a broker member of the New York Stock Exchange, sues to rescind a transaction in which it acted as a broker for the defendant Arkus-Duntov ("Duntov") in the sale of 24,475 shares of common stock of Equity Funding Corporation of America ("Equity Funding"). It also seeks to enjoin the payment of two certified checks made to it by Duntov and to the defendant United Missouri Bank of Kansas City ("United Bank") in the

respective amounts of $192,256.35 and $217,448.08, drawn in payment for the stock sold.

A temporary restraining order was signed by this Court on April 3, 1973 enjoining the payment of the two checks by the Chase Manhattan Bank, N.A. ("Chase") on condition that the plaintiff post a bond for the full amount of the checks, $409,704.43, and setting the matter down for hearing on a preliminary injunction on April 9, 1973 at 10 a.m.

The hearing was begun on April 9 and was adjourned after the completion of the plaintiff's case, subject to the immediate taking of the deposition of Duntov by the plaintiff and the resumption of the hearing of April 10 at 3 p.m. The hearing continued on April 10 and was concluded that evening.

The affidavits admitted in evidence by consent and the oral testimony reveals the following.

Duntov was on March 26, 1973 an Executive Vice President of Equity Funding. He was also a member of its five man executive committee and of its nine member board of directors.

On March 26, 1973 Jefferies was asked by North American Equity Corporation ("North American"), a broker dealer which was a 100% subsidiary of Equity Funding, to sell 24,475 shares of Equity Funding common stock on the Stock Exchange. Jefferies effected the sales on the New York Stock Exchange that day at prices ranging from 16-1/2 to 17-3/8. There was no disclosure to Jefferies at the time of the order that the sale was for the account of Duntov, or

that he was an Executive Vice President and a director of Equity Funding.

The settlement date for the March 26 sales was April 2. Before the settlement date arrived, on March 27 at 12:45 p.m. E.S.T., the next day after the sales in question, the New York Stock Exchange halted trading in Equity Funding common stock. On March 28 the Securities and Exchange Commission ("Commission") suspended trading in all securities of Equity Funding. On April 2, the board of directors, including Duntov, voted to have Equity Funding consent to a final judgment of permanent injunction sought by the Commission. They also "informed the corporation that they will resign their directorships upon the appointment of a new board of directors. . ." (¶ 3 of consent to final judgment).

On April 3, 1973 the Commission instituted an action in the United States District Court for the Central District of California charging that Equity Funding was engaged in acts and practices constituting violations of §§10(b), 13(a) and (b) and 14(a) of the 1934 Act. Specifically, the complaint alleged that Equity Funding engaged in "a massive and prolonged effort to alter its books and records, principally those of Equity Funding Life Insurance Company (EFLIC), to show the sales of insurance policies, the receipt of premium payments, the creation of assets and the establishment of reserves, when, in fact, such insurance policies had not been sold, premium payments had not been received, assets did not exist, and the reserves had not been established." The complaint further alleges that Equity Funding "acting

through certain of its officers and employees and those of its subsidiaries, principally EFLIC, caused insurance policy files to be created and maintained in the names of fictitious persons, persons whose policies had lapsed, persons who had applied for but were denied insurance, and caused insurance policies to be issued to persons upon which no premiums were paid and caused the face amount of existing policies to be increased without the knowledge of the policyholder." It is also alleged that Equity Funding "caused said policies and fictitious insurance policies to be sold or conveyed to co-insurers and re-insurers and received therefrom payments of monies in excess of premiums purportedly received by EFLIC on the initial sales" and that Equity Funding "caused death claims on said fictitious and false policies to be

presented to the co-insurers and re-insurers in order to collect death benefits thereon, and surrendered a number of said fictitious and false policies in order to receive the cash surrender values thereon." Finally, the Commission's complaint asserts that Equity Funding "caused financial statements to be prepared and disseminated to the investing public reflecting substantial earnings which were in fact false and fictitious" and that it "caused such false and fictitious financial statements to be filed with the Commission and other regulatory agencies, including the New York Stock Exchange and the state insurance authorities, and in such manner did thereby willfully, fraudulently and falsely report and represent the financial condition of Equity Funding Corporation and its subsidiaries."

As indicated, Equity Funding consented to the injunction on April 3.

Earlier on April 2 the California Insurance Department instituted an action in the Superior Court of the State of California entitled "Payne, Insurance Commissioner v. Equity Funding Life Insurance Company" in which the Commissioner asked the Court to appoint a conservator for EFLIC, a subsidiary of Equity Funding. The verified application stated that the California Insurance Commissioner had been notified by the Illinois Insurance Commissioner that $24,000,000 in bonds, represented by EFLIC to have been on deposit with the American Bank of Chicago were not on deposit as represented. The California Commissioner also charged that there were life insurance

policies recorded on the books of EFLIC which were wholly fictitious.

Other official actions occurred within a few days of the large stock sale by Duntov, with the likelihood that there were rumblings to important officers earlier. Moreover, on March 12, 1973 the Illinois Insurance Department had begun a surprise audit of the financial condition of EFLIC. Preliminary investigation disclosed that a substantial number of bogus policies had been issued by EFLIC and that 20 million dollars of bonds listed as its assets and purportedly held by the American National Bank of Chicago were not there. The investigation, commenced on March 12, had advanced so far by April 2 that on the latter date a verified petition was filed in the case of People ex rel. Fred A. Mauck, Director of Insurance of the State

of Illinois v. Equity Funding Life Ins. Co., & Equity Funding Corp. of America (No. 73-1019-Cir) in the Circuit Court for the 18th Judicial Circuit, DuPage County, Illinois.

On April 3 Equity Funding and EFLIC were ordered to cease and desist from various activities including the selling of life insurance in Illinois.

Although, in the time available, the plaintiff has been unable to pinpoint exactly when the executive officers and directors learned of the serious violations that were uncovered in the Illinois investigation, it is a fair inference that notice must have been brought home to the directors of Equity Funding that all was not ship-shape some time before the suspension of trading on March 28. The sales of stock here involved were made only

a week before official court action by the Commission and the Insurance Commissioners. It is a fair inference that the Illinois investigation, by then two weeks old, had come into the ken of directors and officers like Duntov, although Duntov has denied knowing that it was anything but a routine triennial examination.

The sudden sale of 24,475 shares plus about an additional 16,000 shares, representing about 80% of Duntov's holdings (49,911 shares) of Equity Funding within a week before the board agreed to a consent injunction is highly suspicious. That is particularly true because in November, 1972 Duntov sold only 300 shares and in December, 1972 only 900 shares. In the two and a half years before the March 26, 1973 trades he never sold more than 2,000 shares

in a month, and only in March, 1971 did he sell as many as 2,000.

Let us now revert to the activities of Jefferies from March 26 when it received the order to sell from North American to present. On March 26, Jefferies sold the entire block of 24,475 shares to member firms. The Stock Clearing Corporation by a balance order told Jefferies to deliver a net balance of 19,300 shares to Hayden, Stone, a member firm, and the balance to other brokers. On March 29, confirmation slips had been received by Jefferies from North American indicating that delivery of the 24,475 shares would be made by United Bank.

On the settlement date, April 2, a total of 24,475 shares were presented at the New York office of Jefferies; certificates representing 13,000 shares

were presented by United Bank and certificates for the remaining 11,475 shares were presented by the Franklin National Bank ("Franklin"). The confirmations from United Bank had not shown on their face the name of "Duntov" but the certificates were all in the name of "Yura Arkus-Duntov," and directed payment to be made to the latter at 60 East 40th Street, New York. The confirmations from North American also disclosed that the sale was for the account of "Yura Arkus-Duntov."

On April 2, pursuant to written instructions from Franklin and United Bank, Jefferies drew the two checks on Chase, as stated above. Later on April 2, the settlement date, John Muscara, an officer of Jefferies in charge of its clearance department, told Adam A. Halaszynski of the

Los Angeles office of Jefferies that one of the checks had been made to "Yura Arkus-Duntov." Inquiry was made in Los Angeles and Muscara was informed by his Los Angeles office that Duntov was an officer of Equity Funding and an insider, which Muscara had not known up to that time. The information was given to Muscara at about 9 a.m. New York time on April 3. By that time Muscara had already delivered the checks for the proceeds of the sale.

When Muscara found out that Duntov was an officer and presumably an insider of Equity Funding, he made the decision to call Hayden, Stone and "invite" them to return the stock. Hayden, Stone still had the shares in their possession, and gave them back to Jefferies that day, reversing the transaction. The opposite number to Muscara at Hayden, Stone, a Vice President

named Anthony Fidele, testified that he knew nothing of Jefferies "inviting" the stock back. All Fidele knew was that his cashier saw the name "Duntov" on the stock certificates and recognized him as an officer of Equity Funding. Hayden, Stone refused to accept delivery, on Fidele's version, on April 2.

This left Jefferies holding 19,300 shares of stock which it had sold to Hayden, Stone for the account of Duntov, but with two checks outstanding for $409,704.43 which it had sent out on April 2, after assuming that it had been credited by the stock clearing house with the net proceeds from the sales of March 26.

In the meantime the checks had been certified, not by Jefferies but by United Bank and by Duntov.

On April 3 Duntov obtained the restraining order from this Court with a show cause order returnable on April 9. Before the return date, on April 6, the Wall Street Journal carried the story that the New York Stock Exchange had ruled that trades in Equity Funding stock made before the suspension of trading were to be honored. At this juncture Muscara clipped the item from the newspaper, attached it to the certificates of stock and redelivered to Hayden, Stone on April 6, requesting payment under the Exchange's ruling. Hayden, Stone refused to accept delivery, writing on the delivery slip "see ruling." When Muscara got the stock back he called Hayden, Stone to find out what they meant by the notation and was told, as he wrote it on the slip, "105B SEC Rule 7920-1934-Sec. 29."

Muscara understood this to mean that Hayden, Stone was not required to accept a fraudulent transaction.

United Bank comes into the picture in the following way. Duntov had an outstanding loan at the Bank in the amount of $210,000. The loan was secured by 27,692 shares of common stock of Equity Funding. On March 26, Duntov instructed United Bank "to sell from the total common stock of Equity Funding Corp. of America held as collateral for my account the number of shares required to repay my total indebtedness -- $210,000 plus accrued interest through settlement date" (Ex. 1, telegram attached to Affd. of Theodore C. Chapman). The Bank was instructed to sell the shares, which amounted to 13,000, through North American. It did so and was later informed that Duntov had also sold an

additional 12,000 shares of the 27,692 shares held by the Bank.

On March 27, the Bank was informed by North American that settlement of the 13,000 share sale would be made in New York through Jefferies. On March 28, Duntov's office instructed the Bank to send the additional 12,000 shares mentioned to New York for settlement through Donaldson Lufkin & Jenretts, Inc. ("Donaldson").

United Bank arranged for delivery of the additional 12,000 shares for April 3, the day after the settlement date so that payment of the 13,000 shares which were sold for settlement on Monday, April 2, would already have wiped out the loan. (Ex.1, attached to Affd. of Byron McReynolds). On April 2, United Bank was informed by Duntov's office that April 2 was also the settlement date for the 12,000

shares and that they had to be delivered that day. The Bank, as a courtesy to Duntov, concluded to certify the Jefferies check to it, which would amount to $217,448, and release the other 12,000 shares for late delivery to Donaldson that same day.

On April 2 at 11 a.m. United Bank's security clearing office in New York delivered to Jefferies certificates representing the 13,000 shares in the name of Duntov. At 1:30 p.m. it picked up Jefferies' check for $217,448.08, promptly had it certified by Chase and deposited it that afternoon to its account at Manufacturers Hanover Bank.

At about 3 p.m. on April 3, United Bank received a call from Jefferies advising that they were going to stop payment on the certified check.

In recapitulation it appears that Duntov on March 26 sold a total of 40,000 to 41,000 shares of Equity Funding common, of which 24,475 were sold through Jefferies and 12,000 through Donaldson.

The defendant Duntov contends that the plaintiff has failed to state a claim for relief and is, therefore, not entitled to an injunction. He contends that Jefferies has no standing to sue Duntov, its customer, under §12 of the 1933 Act or §10(b) of the 1934 Act, because Jefferies is neither the ultimate purchaser nor a "forced" purchaser of the securities involved. He also contends that the plaintiff is not a purchaser because of the doctrine of Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2 Cir. 1952). Finally, he contends that an injunction should not be granted, in any event,

because there is no showing that the plaintiff is likely to succeed in this litigation and because there is not showing that the plaintiff will be irreparably harmed.

The complaint itself, drawn hastily, does not allege that the plaintiff was a "purchaser" of the Equity Funding stock. It merely alleges that the plaintiff sold stock for the defendants, which was not registered, in violation of §5 of the Securities Act, and that "in connection with" the sale the defendants employed a scheme to defraud. While it alleges that the plaintiff has been damaged in the amount of $409,704.43 it does not say how or why. It seeks rescission of "the sale by plaintiff of the shares on behalf of North American, Duntov and United Missouri."

The assumption that the "sale" sought to be rescinded was a sale by Jefferies to the member firms who bought Equity Funding stock for it was apparently based on the information given to the draftsman of the pleading by Muscara, in charge of Jefferies' clearances, that when he discovered on April 3 from Jefferies Los Angeles office that Duntov was an Executive Vice President of Equity Funding, he called someone at Hayden, Stone "inviting" them to disaffirm the transaction, and Hayden, Stone returned the certificates.[1] If that was truly the situation on April 3 when the complaint was verified by Muscara, the status of Jefferies was that of a volunteer, and the complaint could not allege that Jefferies was a "forced" purchaser because of a refusal by Hayden, Stone to take delivery. We put aside for

the moment the right of a selling broker to rescind a sale against his principal when he discovers that alleged securities laws violations have been committed only after he has actually sold the securities.

For certain events occurred after April 3 which, while not presently the subject of an amended complaint, can be made such. Fed.R.Civ.P 15(b). On April 6, Jefferies re-tendered delivery of 19,300 shares of Equity Funding common to Hayden, Stone on the basis of a ruling by the New York Stock Exchange that all trades before the stop on trading should be honored. This time it is clear that it was Hayden, Stone which unequivocally refused to accept the stock, apparently claiming that the trade was void under §29 of the Exchange Act, 15 U.S.C. § 78cc.[2]

On that state of facts, Jefferies now has the shares only because Hayden, Stone refused to accept delivery on the ground that Duntov had allegedly violated the securities laws.[3] Jefferies now seeks to give the shares back to Duntov. But it cannot simply return the shares and wait to be sued by Duntov because it had issued checks for the proceeds in the mistaken belief that it had already been credited with the proceeds of sale by the stock clearing corporation -- all before it discovered that the certificates delivered on April 2 were registered in the name of Duntov and that he was an officer and director of Equity Funding. Jefferies had thus become a "forced" purchaser of the shares from its customer, Duntov.

In American Bank & Trust Co. v. Barad Schaff, 335 F.Supp. 1276 (S.D.N.Y. 1972),

this Court held that a bank, whose customer defaulted on repaying the moneys advanced by the bank to pick up securities for the customer's account, has standing to sue an allegedly defrauding seller of unregistered securities both under § 12 of the Securities Act and § 10(b)-5 of the Exchange Act. I noted there that "the purpose of affording a private remedy by statute (§ 12) was primarily to discourage the sale of securities without registration" (at 1280) and that the statutory remedy is not limited to "investors." In sum, the bank there, for reasons beyond its control, ended up being a "purchaser from him" (§ 12) the fraudulent seller "as if it had acquired the stock directly from the fraudulent seller" (at 1279).

Adhering to my ruling in the American Bank case that privity was not required for standing to sue under § 12 in the unusual circumstances of that case, the same ratio decidendi applies to the standing of Jefferies to sue. In the American Bank case it was the purchaser-customer who defaulted; in this case it is the seller-customer who refused to accept rescission. The result is the same in either case. The plaintiff has become an involuntary purchaser of either an allegedly unregistered security or of a security in connection with which there has been an alleged § 10(b) violation.

A.T. Brod v. Perlow, 375 F.2d 393 (2 Cir. 1967) established that although a broker is an agent for his customer, he may nonetheless sue the customer who defrauded him in violation of the Exchange Act.

Judge Kaufman noted that Rule 10b-5 "was designed to protect both investors and "the public interest.' We cannot understand . . . any rationale which would restrict or inhibit appropriate private rights of action to enforce the Rule to those brought by 'investors'" (375 F.2d at 396; emphasis in original).

Although the Brod case, supra, did not involve § 12, its reasoning is applicable. In any event, it is authority for the standing of Jefferies under § 10(b). The broker-plaintiff in Brod was held to be a "purchaser" (375 F.2d at 397).

This liberal interpretation of standing is essential to preserve the integrity of the securities markets. As Judge Timbers said recently: "The securities laws seek to prevent restrictions which distort the market's

estimate of value." Chris-Craft Industries, Inc. v. Piper Aircraft Corporation, 2 Cir., 480 F.2d 341 at 357.

Nor can it be doubted that there is causation here. The defendant Duntov set in motion a force which was meant to affect investors, but the selling broker became the victim. Cf.Heit v. Weitzen, 402 F.2d 909 (Cir. 1968).

The contention that the Birnbaum rule destroys the standing of the broker to sue for violations of Rule 10b-5 is refuted by A.T. Brod v. Perlow, supra. And the Supreme Court has recently taught that a fraud in connection with a purchase and sale that was not the initial purchase and sale may, nevertheless, be actionable. Supt. of Ins. of N.Y. v. Bankers Life & Cas. Co., 404 U.S. 6, 92 S. Ct. 165, 30 L.Ed.2d 128 (1971).

The gravamen of the complaint on Rule 10b-5 is that Duntov employed a device, scheme and artifice to defraud the plaintiff and engaged in fraud and deceit in that he omitted to state material facts to the plaintiff with respect to the business, operations and financial condition of Equity Funding and its subsidiary EFLIC. These omitted facts are alleged to have been that (a) the price of Equity Funding stock had been artificially inflated by the defendant and others; and that (b) "the assets, insurance in force, sales and earnings of Equity Funding, and of its subsidiary, Equity Life, had been falsely inflated by, among other things, including an unknown but substantial amount of 'bogus' life insurance coverage that did not exist -- which was resold for cash to

other insurance companies that reinsured the business" (¶13).

Strangely enough the complaint relies entirely on the theory that Duntov knew of the alleged unlawful practices themselves but fails to allege that, whether he knew of them or not, he was sufficiently alerted inside the corporation during the week preceding the sales of the charges and investigations and the imminence of suspension of trading to make the inside information a factor foridding the sale by him of his Equity Funding securities. Though Muscara sensed this, as did Hayden, Stone, the pleader failed to state a claim for relief based on these considerations.

Nevertheless, since the facts are before the Court, an amendment of the pleadings to conform will be allowed.

I do not now find that Duntov knew of the alleged stock manipulations or the "bogus" policies and the like. That should be stated in fairness to him. It is his position that, although he was one of the six Executive Vice Presidents, his duties were limited to supervision of the mutual funds, to troubleshooting, and to service on the board of life insurance companies other than the suspected EFLIC. The plaintiff claims that he "should have known" the facts, but that is not enough. Scienter is still required. S.E.C. v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1096, n. 15 (2 Cir. 1972).

On the other hand, his mere denial of knowledge from inside sources that there was something seriously amiss is not enough. His knowledge of the Illinois investigation, of the charges by one Dirks

of serious fraud which he learned from in-house conversations, his feeling that trading would soon be halted, all add up to make him an "insider" prohibited from dumping his stock, at least prima facie, S.E.C. v. Texas Gulf Sulphur Co., 401 F.2d 833 (2 Cir. 1968) (en banc), cert. denied sub. nom. Kline v. S.E.C., 394 U.S. 976, 89 S. Ct. 1454, 22 L.Ed.2d 756 (1969).

The complaint alleges that the securities sold by Duntov were not, although such securities were required to be, registered pursuant to § 5 of the Securities Act. Duntov counters by noting in an affidavit that the shares were acquired by him pursuant to the exercise of stock options under the 1968 Qualified Stock Option Plan of Equity Funding and were registered under the the Securities Act pursuant to Equity Funding's

Registration Statement on Form S-1, which was declared effective on May 24, 1972 and was at the time of sale covered by post-effective amendment No. 2 to that Registration Statement dated September 11, 1972.

These facts are not contested and there is no doubt that, in form, there was extant an effective registration. But that is only part of the story. Any material infirmity in the prospectus accompanying the Registration Statement affected the marketability of his stock (1933 Act, § 5(b) (2), 15 U.S.C. § 77e). See S.E.C. v. Manor Nursing Centers, Inc., supra.

The claim is now that enough has come to light from public sources, the Commission and the Insurance Commissioner, as well as from the filing of a petition for reorganization under Chapter X of the

Bankruptcy Act to make suspect the sufficiency of the prospectus because of material misstatements and omissions. Such material omissions and misstatements would give rise to a claim under § 12 based on a violation of § 5 of the 1933 Act. S.E.C. v. Manor Nursing Centers, Inc., supra.

I find then that the plaintiff has standing to sue Duntov under § 12 of the Securities Act and under § 10(b) of the Exchange Act. I find that there is jurisdiction under the Birbaum rule. I find that causation can be established as a matter of law since the broker was harmed by the alleged securities violations. And I find that presumptively on the facts thus far adduced, Duntov was an insider possessed of inside information who was not at liberty to sell his holdings.

Although this is dispositive of the substantive legal points raised, perhaps a word should be said in support of the temporary restraining order which, as it now appears, was based on the status of Jefferies as a self-enforcer of the securities laws who "invited" Hayden, Stone to rescind.

An underwriter can certainly rescind an underwriting commitment where the prospectus is found to be materially misleading. Kaiser-Frazer Corp. v. Otis Co., 195 F.2d 838 (2 Cir. 1952). "Contracts for securities" was thought to be a concept larger than "underwriting agreements" alone. 195 F.2d at 844, n. 8. The Court noted "that the contract was so closely related to the performance of acts forbidden by law as to be itself illegal." (Id. at 844).

It should be clear, then, that a broker who finds himself the unwitting agent of a securities violation may similarly cry halt to the transaction. An agent in such circumstances owes no duty to the violator. Indeed, by analogy to the volunteer who rescues a person on a railroad track (Wagner v. International Ry., 232 N.Y. 176, 133 N.E. 437 (1921 Cardozo, J.), the broker is the volunteer rescuer of unknown investors who would otherwise have bought the stock.

If then, as I believe, Jefferies would have been immune from the recovery of damages by Duntov, does the circumstance that it drew the check to Duntov before it knew the facts change the result? In the case of this check, although it was certified in circumstances not shown by the record, it was not passed to a holder in

due course (N.Y.U.C.C. § 3-306.)[4] There has been no change of position by Duntov based on his possession of the check. See American Law Institute, Restatement of Restitution (1937) § 16.[5] See also Restatement of Contracts (1932) § 599, where the comment says: "If the plaintiff is in fact innocent because not aware of the facts which make the transaction illegal, this is enough to enable him to recover from one who has knowledge of the facts, irrespective of misrepresentation." (p. 112).

Where the balance of hardship tips decidely toward the plaintiff, it is not necessary for preliminary relief that he has demonstrated a likelihood of success but only that he has "raised questions going to the merits so serous, substantial, difficult and doubtful, as to make them a

fair ground for litigation and thus for more deliberate investigation." Hamilton Watch Co. v. Benrus Watch Co., 206 F.2d 738, 740 (2 Cir. 1953); see Semmes Motors Inc. v. Ford Motor Co., 429 F.2d 1197, 1205-06 (2 Cir. 1970).

In this case I think the plaintiff is in even better position. Duntov will have to break through the wall of circumstantial evidence that now surrounds him. He is a top officer of Equity Funding who has, by his own testimony at deposition, been conferring all week with the other top officials and who sells 40,000 shares the day before trading in the stock is stopped. That is not to say that his case should be prejudged. He may be able to convince the trier of fact of the merit of his position. But for the time being the circumstances warrant a preliminary injunction to

restrain the cashing of a check if the remedy at law is inadequate.

In normal circumstances a court does not rush to enjoin; but when irreparable injury is threatened, it may in its discretion enjoin. (See Gulf & Western Industries, Inc. v. The Great Atlantic & Pacific Tea Co., 356 F. Supp. 1066, D.C., 1973; Dino DeLaurentiis Cinematografica, Sp.A. v. D-150, Inc., 366 F.2d 373 (2 Cir. 1966).

Here the evidence indicates that Duntov owns a house with an equity of about $130,000 and that aside from the proceeds of another sale of Equity Funding stock made the same day, which may be challenged, he has about $30,000 in cash. His position like that of other employees of Equity Funding is precarious in view of the Chapter X proceeding, and he has already

resigned from the three mutual funds. He is a fair target for derivative and class suits. The plaintiff claims $409,000 in damages for which it drew checks by mistake. In view of my deposition relating United Bank (see infra) the claim against Duntov by the plaintiff will still be $409,000 less the $192,256 held in abeyance until the determination of whether it should be paid to Duntov. In these circumstances, I shall require the plaintiff to post a bond for the full amount of the check in the amount of $182,256.25, and costs, and I shall restrain its collection or payment pendente lite.

THE CLAIM AGAINST UNITED BANK

The claim against United Bank is different. The complaint against it avers that it participated in the sale of

unregistered stock, in the fraudulent manipulation of stock and in the omissions of material facts charged.

The hearing disclosed not one word of proof that United Bank sold any securities. It simply delivered collateral securities to the broker-dealer, North American, named Duntov. There is no proof that it knew anything about the operations or reports of Equity Funding to whom it was a stranger. Nor is there any proof that it was privy to any inside information or even that it speeded up matters to beat the gun.

United Bank had Chase certify the check made to it as a creditor which had released its collateral. Since the additional shares sold by Duntov from his collateral account could not be delivered against payment on April 2, the settlement date, United Bank arranged to deliver the

additional shares and to receive a check which it could certify. I find that, on the evidence, the certification was effected for no ulterior purpose.

United Bank was a holder in due course event though it was the payee named, because its consideration was the antecedent debt and the release of its collateral (U.C.C. §§ 3-303(b), 3-302(2)).

When Chase certified the check for the holder it created a novation in which the drawer was released and Chase substituted as primary debtor (U.C.C. §§ 3-411(1), 4-403).[6] Under the Negotiable Instruments Law, § 323 the same result followed. See Carnegie Trust Co. v. First National Bank, 213 N.Y. 301, 107 N.E. 693 (1915). There Judge Cardozo noted that even if the drawer had certified the check in the mistaken belief that he had no right to set-off, an

action for money paid under mistake would lie. (Id. at 305).

Jefferies made the check to United Bank in the mistaken belief that it had been credited with the proceeds of the sale. The mistake was not induced by United Bank.

Aside from the requirements of the Uniform Commercial Code, equity should, for policy reasons, refrain from interfering with the free flow of commerce. The integrity of the certified check is a valuable asset in our economy. Any innocent holder should not be disturbed in his rightful possession, though the result may mean a windfall for the customer whose loan has been repaid by the questionable means described. The motion to enjoin the payment of the check to Duntov is directed to return the check to Jefferies upon its

posting the bond above mentioned. The bond also shall include indemnification of Chase (N.Y.U.C.C. § 3-603).

The foregoing constitutes findings of fact and conclusions of law under Fed. R.Civ.P. 52(a).

It is so ordered pending settlement of a formal order.

The temporary restraining order is continued to April 20, 1973 at 4 p.m. to permit Jefferies, if so advised, to seek a stay from the Court of Appeals for the Second Circuit.

APPENDIX D

FOOTNOTES

[1]. Hayden, Stone was not the actual buyer. Under the practice of the stock clearing corporation accounts between member firms are settled on a net basis, regardless of who actually sold to whom. On April 2 it happened that Hayden, Stone was entitled to a net delivery of 19,300 from the clearing corporation and Jefferies was obligated to deliver the same amount. Accordingly, Jefferies was instructed to deliver that number of shares to Hayden, Stone to "net out" the day's transactions on Equity Funding common.

[2]. The theory presumably was that Jefferies as broker for Duntov was asserting "the rights of (a) person, who in violation of (a) provision, rule or regulation, shall have made or engaged in the performance of any such contract."

[3]. Hayden, Stone purportedly refused to accept an earlier delivery because delivery was in an improper amount as well.

[4]. Cf. Metropolitan Life Ins. Co. v. Bank of United States, 259 N.Y. 365, 182 N.E. 18)1932).

[5]. Restatement of Restitution (1937) § 16 reads:

§16. Mistaken Belief in Validity of Contract with Payee.

A person who has paid money to another because of an erroneous belief induced by a mistake of fact that in so doing he is performing a contract with the other which is not subject to avoidance, is entitled to restitution of the amount so paid if the transaction is voidable by either party because of the mistake and is avoided."

[6]. The official comment to 4-403 reads:

"5. There is no right to stop payment after certification of a check or other acceptance of a draft, and this is true no matter who procures the certification. See Sections 3-411 and 4-303. The acceptance is the drawee's own engagement to pay, and he is not required to impair his credit by refusing payment for the convenience of the drawer."

APPENDIX E

15 U.S.C. § 77j
INFORMATION REQUIRED IN PROSPECTUS

Information in registration statement; documents not required

(a) Except to the extent otherwise permitted or required pursuant to this subsection or subsections (c), (d), or (e) of this section--

(1) a prospectus relating to a security other than a security issued by a foreign government or political subdivision thereof, shall contain the information contained in the registration statement, but it need not include the documents referred to in paragraphs (28) to (32), inclusive, of schedule A of section 77aa of this title;

(2) a prospectus relating to a security issued by a foreign government or political subdivision thereof shall contain the information contained in the registration statement, but it need not include the documents referred to in paragraphs (13) and (14) of schedule B of section 77aa of this title;

(3) notwithstanding the provisions of paragraphs (1) and (2) of this subsection when a prospectus is used more than nine months after the effective date of the registration statement, the information contained therein shall be as of a date not more than sixteen months prior to such use, so far as such information is known

to the user of such prospectus or can be furnished by such user without unreasonable effort or expense;

(4) there may be omitted from any prospectus any of the information required under this subsection which the Commission may by rules or regulations designate as not being necessary of appropriate in the public interest or for the protection of investors.

APPENDIX F

§771

Civil liabilities arising in connection with prospectuses and communications

Any person who--

(1) offers or sells a security in violation of §77e of this title, or

(2) offers or sells a security (whether or not exempted by the provisions of §77c of this title, other than paragraph (2) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes

an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the reconsideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for

damages if he no longer owns the security.

APPENDIX G

§77e

Prohibitions relating to interstate commerce and the mails

(a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly--

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or

(2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

Necessity of prospectus meeting requirements of section 77j of this title

(b) It shall be unlawful for any person, directly or indirectly--

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to carry or transmit any prospectus relating to any security with respect to which a registration statement has been filed under this subchapter, unless such prospectus meets the requirements of section 77j of this title; or

(2) to carry or cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale, unless accompanied or

preceded by a prospectus that meets the requirements of subsection (a) of section 77j of this title.

APPENDIX H

15 U.S.C. § 77b(11)

DEFINITIONS

(11) The term "underwriter" means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission. As used in this paragraph the term "issuer" shall include, in addition to an issuer, any

person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.

APPENDIX I

§ 77d. Exempted Transactions

The provisions of § 77e of this title shall not apply to--

(1) transactions by any person other than an issuer, underwriter, or dealer. . .

(4) brokers' transactions executed upon customers' orders on any exchange or in the over-the-counter market but not the solicitation of such orders. . .

APPENDIX J

RULE 15. Amended and Supplemental Pleadings

(a) **Amendments.** A party may amend his pleading once as a matter of course at any time before a responsive pleading is served or, if the pleading is one to which no responsive pleading is permitted and the action has not been placed upon the trial calendar, he may so amend it at any time within 20 days after it is served. Otherwise a party may amend his pleading only be leave of court of or by written consent of the adverse party; and leave shall be freely given when justice so requires. A party shall plead in response to an amended pleading within the time remaining for response to the original pleading or

within 10 days after service of the amended pleading, whichever period may be the longer, unless the court otherwise orders.

(b) **Amendments to Conform to the Evidence.** When issues not raised by the pleadings are tried by express or implied consent of the parties, they shall be treated in all respects as if they had been raised in the pleadings. Such amendment of the pleadings as may be necessary to cause them to conform to the evidence and to raise these issues may be made upon motion of any party at any time, even after judgment; but failure so to amend does not affect the result of the trial of these issues. If evidence is objected to at the trial on the ground that it is not within the issues made by the pleadings, the court

may allow the pleadings to be amended and shall do so freely when the presentation of the merits of the action will be subserved thereby and the objecting party fails to satisfy the court that the admission of such evidence would prejudice him in maintaining his action or defense upon the merits. The court may grant a continuance to enable the objecting party to meet such evidence.

APPENDIX K

RULE 22. INTERPLEADER

(1) Persons having claims against the plaintiff may be joined as defendants and required to interplead when their claims are such that the plaintiff is or may be exposed to double or multiple liability. It is not ground for objection to the joinder that the claims of the several claimants or the titles on which their claims depend do not have a common origin or are not identical but are adverse to and independent of one another, or that the plaintiff avers that he is not liable in whole or in part to any or all of the claimants. A defendant exposed to similar liability may obtain such interpleader by way of cross-claim or

counterclaim. The provisions of this rule supplement and do not in any way limit the joinder of parties permitted in Rule 20.

(2) The remedy herein provided is in addition to and in no way supersedes or limits the remedy provided by Title 28, U.S.C., §§ 1335, 1397 and 2361. Actions under those provisions shall be conducted in accordance with these rules.

APPENDIX L

RULE 41. DISMISSAL OF ACTIONS

(a) Voluntary Dismissal: Effect Thereof.

(2) By Order of Court. Except as provided in paragraph (1) of this subdivision of this rule, an action shall not be dismissed at the plaintiff's instance save upon order of the court and upon such terms and conditions as the court deems proper. If a counterclaim has been pleaded by a defendant prior to the service upon him of the plaintiff's motion to dismiss, the action shall not be dismissed against the defendant's objection unless the counterclaim can remain pending for independent adjudication by the court. Unless otherwise specified in the order,

a dismissal under this paragraph is without prejudice.

APPENDIX M

17 C.F.R. § 230.144(g)

Persons deemed not to be engaged in a distribution and therefore not underwriters

PRELIMINARY NOTE

Rule 144 is designed to implement the fundamental purposes of the Act, as expressed in its preamble, "To provide full and fair disclosure of the character of the securities sold in interstate commerce and through the mails, and to prevent fraud in the sale thereof . . ." The rule is designed to prohibit the creation of public markets in securities of issuers concerning which adequate current information is not available to the public. At the same time, where adequate current information concerning the issuer is available to the public, the rule permits the public sale in ordinary

trading transactions of limited amounts of securities owned by persons controlling, controlled by or under common control with the issuer and by persons who have acquired restricted securities of the issuer.

Certain basic principles are essential to an understanding of the requirement of registration in the Act:

1. If any person utilizes the jurisdictional means to sell any nonexempt security to any other person, the security must be registered unless a statutory exemption can be found for the transaction.

2. In addition to the exemptions found in section 3, four exemptions applicable to transactions in securities are contained in section 4. Three of these section 4 exemptions are clearly not available to anyone acting as an

"underwriter" of securities. (The fourth, found in section 4(4), is available only to those who act as brokers under certain limited circumstances.) An understanding of the term "underwriter" is therefore important to anyone who wishes to determine whether or not an exemption from registration is available for his sale of securities.

The term underwriter is broadly defined in section 2(11) of the Act to mean any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates, or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking.

The interpretation of this definition has traditionally focused on the words "with a view to" in the phrase "purchased from an issuer with a view to . . .distribution." Thus, an investment banking firm which arranges with an issuer for the public sale of its securities is clearly an "underwriter" under that section. Individual investors who are not professionals in the securities business may also be "underwriters" within the meaning of that term as used in the Act if they act as links in a chain of transactions through which securities move from an issuer to the public. Since it is difficult to ascertain the mental state of the purchaser at the time of his acquisition, subsequent acts and circumstances have been considered to determine whether such person took with

a view to distribution at the time of his acquisition. Emphasis has been placed on factors such as the length of time the person has held the securities and whether there had been an unforeseeable change in circumstances of the holder. Experience has shown, however, that reliance upon such factors as the above has not assured adequate protection of investors through the maintenance of informed trading markets and has led to uncertainty in the application of the registration provisions of the Act.

It should be noted that the statutory language of section 2(11) is in the disjunctive. Thus, it is insufficient to conclude that a person is not an underwriter solely because he did not purchase securities from an issuer with a view to their

distribution. It must also be established that the person is not offering or selling for an issuer in connection with the distribution of the securities, does not participate or have a direct or indirect participation in any such undertaking, and does not participate or have a participation in the direct or indirect underwriting of such an undertaking.

(g) Brokers' transactions. The term "brokers' transactions" in section 4(4) of the Act shall for the purposes of this rule be deemed to include transactions by a broker in which such broker:

(1) Does not more than execute the order or orders to sell the securities as agent for the person for whose account the securities are sold; and

receives no more than the usual and customary broker's commission;

(2) Neither solicits or arranges for the solicitation of customers' orders to buy the securities in anticipation of or in connection with the transaction; provided, that the foregoing shall not preclude (i) inquiries by the broker of other brokers or dealers who have indicated an interest in the securities within the preceding 60 days, (ii) inquiries by the broker of his customers who have indicated an unsolicited bona fide interest in the securities within the preceding 10 business days; or (iii) the publication by the broker of bid and ask quotations for the security in an inter-dealer quotation system provided such quotations are incident to the maintenance of a bona fide inter-dealer

market for the security for the broker's own account and that the broker has published bona fide bid and ask quotations for the security in an inter-dealer quotation system on each of at least twelve days within the preceding thirty calendar days with no more than four business days in succession without such two-way quotations;

Note to Paragraph (g)(2)(ii): The broker should obtain and retain in his files written evidence of indications of bona fide unsolicited interest by his customers in the securities at the time such indications are received.

(3) After reasonable inquiry is not aware of circumstances indicating that the person for whose account the securities are sold is an underwriter with respect to the securities or that

the transaction is a part of a distribution of securities of the issuer. Without limiting the foregoing, the broker shall be deemed to be aware of any facts or statements contained in the notice required by paragraph (h) of this section.

NOTES: (i) The broker, for his own protection, should obtain and retain in files a copy of the notice required by paragraph (h) of this section.

(ii) The reasonable inquiry required by paragraph (g)(3) of this section should include, but not necessarily be limited to, inquiry as to the following matters:

(a) The length of time the securities have been held by the person for whose account they are to be sold. If practicable, the inquiry should

include physical inspection of the securities;

(b) The nature of the transaction in which the securities were acquired by such person;

(c) The amount of securities of the same class sold during the past 3 months by all persons whose sales are required to be taken into consideration pursuant to paragraph (e) of this section;

(d) Whether such person intends to sell additional securities of the same class through any other means;

(e) Whether such person has solicited or made any arrangement for the solicitation of buy orders in connection with the proposed sale of securities;

(f) Whether such person has made any payment to any other person in

connection with the proposed sale of the securities; and

(g) The number of shares or other units of the class outstanding, or the relevant trading volume.